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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Proposals to Revise the Methodology for Determining Universal Service Support	)	**CC Docket Nos. 96-45 and 97-160**
	)	
Amendment of the Commission's Rules and Policies Governing Pole Attachments	)	

COMMENTS OF MCI

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Executive Summary

Any Universal Service funding mechanism must be based on sound public policy principles. In these comments, MCI enunciates those principles, reviews the proposals submitted to date in light of those principles and finds none of them meet the principles, and then puts together the positive elements from the various proposals to construct a high cost Universal Service funding mechanism for non-rural LECs that is consistent with sound public policy principles.

The Universal Service funding burden is, in effect, an assessment, and like all governmental assessments it must be sized and applied in a manner that furthers consumer welfare as a whole, taking into account the social policies furthered by the Universal Service fund. The Universal Service subsidy must be defined as the difference between forward-looking economic costs and a nationwide affordability benchmark. For every dollar of explicit subsidy collected, the current implicit subsidies must be decreased a dollar, or customers will be double billed and LECs will enjoy a windfall double recovery. Both fairness and competitive neutrality demand that, to the fullest extent possible, the carriers and customers who bear the burden of the new explicit assessment, and already are contributing to existing implicit subsidies, be the ones who gain the reduction in the implicit burden. Thus, if funding for an explicit subsidy comes from interstate carriers and their customers, there must be commensurate reductions in the above-cost interstate rates that are providing implicit subsidies.

Universal Service funding mechanisms must be structured for administrative efficiency and ease and must be imposed in a competitively-neutral fashion. Competitive neutrality involves the means by which the assessment is collected as well as the way it is disbursed. Finally, the

Universal Service fund must be implemented in a fashion that is consistent with implementation of other key elements of the Telecommunications Act. In particular, the size of the Universal Service subsidy must be calculated based on the same degree of unbundled loop rate deaveraging states use to set unbundled loop prices.

All the proposals submitted to date have serious flaws that render them inconsistent with sound public policy principles. The State Proposals would harm consumers and competition in order to solve a problem that does not exist. These proposals would impose a double burden on interstate customers and would give non-rural LECs double recovery of some costs. The State Proposals are based on the mistaken belief that two Commission actions — the proposal to fund only 25 percent of the Universal Service subsidy from the interstate jurisdiction; and the decision requiring non-rural carriers that draw upon high cost support to reduce interstate access charges, thereby shifting revenue requirements to the states — could result in states having to raise rural rates beyond the range of affordability. The State Proposals therefore seek to create an explicit interstate fund and would only decrease above-cost rates for intrastate services. Ironically, the State Proposals would harm rural customers.

Rather than creating a misguided Universal Service funding mechanism, the Commission could correct this jurisdictional impact anomaly simply, and appropriately, by clarifying its rules to allow non-rural carriers to continue to book costs pursuant to 47 U.S.C. § 36.361 and apply the funds they withdraw for high cost purposes to this specific interstate revenue requirement before reducing interstate access charges.

GTE and BellSouth propose inflated Universal Service funding mechanisms by alleging that all above-cost rates represent Universal Service subsidies; their proposals must be rejected.

South Dakota and Colorado propose varying the affordability benchmark across states according to some measure of a state's ability to internally support Universal Service, but these are less efficient and less fair ways to achieve the goal of Universal Service than the MCI or FCC funding mechanisms.

MCI develops a mechanism consistent with sound policy principles. Features of MCI's mechanism are contained in other proposals under consideration, but other proposals violate, or are silent, on one or more of the principles. MCI wishes to stress that all of these principles must be incorporated in order for a Universal Service fund to be sufficient and foster competition. MCI recommends the Commission adopt a Universal Service mechanism for non-rural carriers funded solely from the interstate jurisdiction and sized according to the degree of rate deaveraging states have implemented for unbundled loops. The mechanism would estimate the size of the fund comparing forward-looking costs to a national affordability benchmark. Forward-looking costs would be calculated for the same geographic zones each state has established for unbundled loops. States that have done the greatest deaveraging of loop rates, to most closely reflect underlying costs, and therefore have removed a barrier to competitive entry, will receive larger subsidies than states that have not taken such action. This is appropriate because competition that could threaten the implicit subsidies in above-cost rates could only develop where UNE loop rates have been deaveraged, and that is where the implicit subsidies must be replaced by explicit ones. The mechanism would collect revenues for the fund according to the revenue share of each provider of interstate retail services. LECs would be prohibited from recovering the assessment on their retail interstate services from their wholesale customers (the IXCs) through the inclusion of these costs in access charges, and all contributors should be encouraged to identify the

Universal Service assessment on customer bills as a federal high cost Universal Service fee. The mechanism would concurrently reduce implicit interstate subsidies for every new dollar removed from the new explicit Universal Service fund, in the following order: (1) pay off the additional interstate revenue requirement allocation made under Rule 36.631; (2) reduce interstate access charges, starting with the CCLC, then, if needed, the PICC, and then, if needed, the local switching charge. Since the entire national high cost Universal Service fund for non-rural LECs is being funded from interstate services, any state Universal Service fund must be imposed only on intrastate services and collected only from intrastate rates.

I. Introduction

In Public Notice DA 98-175, released April 15, 1998, the Commission sought comments on various proposals for a high-cost Universal Service fund for non-rural local exchange carriers (LECs). Universal Service reform is one of the "trilogy" of policy issues that the Commission has identified as essential for implementation of the Telecommunications Act of 1996 (the Act),[1] all three of which have to be in place for competition to develop.

In the Act, Congress constructed a new regulatory framework to foster competition in the local telecommunications market based on its belief that customers' needs are better met through competitive forces than by monopolies. The framework was built in part on the recognition that the implicit subsidies that currently provide Universal Service funding support are anticompetitive and, while viable as long as there are barriers to competition that prevent market forces from eroding those rates that were kept above cost to provide the subsidy, could not be maintained if in fact those barriers were removed and competition developed.

The objectives of this rulemaking therefore must be (1) to replace the implicit Universal Service funding mechanisms with an explicit fund that is consistent with the competitive provisions of the Act, and (2) as a corollary, to coordinate the timing of this Universal Service reform with the timing of the unbundling, pricing, and access charge reform activities that must be performed concurrently to create the framework envisioned by Congress. These can best be accomplished by constructing a Universal Service funding mechanism that provides incentives for the implementation of the other pro-competitive provisions of the Act.

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[1]The other two are implementation of the interconnection/unbundling provisions of the 1996 Act and access charge reform.

These comments are presented in three related parts. First, MCI enunciates the sound public policy principles that must underlie any Universal Service funding mechanism. In Section 254(b) of the Act, Congress effectively codified Universal Service as a public policy subsidy that should be funded in a competitively neutral fashion. Although Congress did not seek to fund this subsidy from general tax revenues, that funding burden (sometimes called Universal Service support) is effectively an assessment on whoever ultimately provides the funds, and therefore can and should be scrutinized according to well-recognized principles of micro-economics. Second, MCI examines the various Universal Service proposals from the perspective of these sound public policy principles. Each of the proposals submitted to the FCC has major flaws that argue against its implementation,[2] but several of the proposals have elements that could be incorporated into an effective Universal Service funding mechanism. Third, MCI puts together the positive elements from the various proposals to construct a Universal Service funding proposal consistent with the sound public policy principles.

II. A high-cost Universal Service fund for non-rural LECs must be based on sound public policy principles

The Act requires the implementation of an explicit Universal Service funding mechanism to replace the current system of implicit subsidies that are hidden in the charges for various services. An explicit funding mechanism can take many forms, not all of which would be consistent with the objectives of the Act or sound public policy principles. It is possible, however, to enunciate public policy principles that should be followed when constructing the explicit funding mechanism.

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[2]Indeed, the FCC proposal, though in many ways flawed, is superior to any of the other proposals submitted to date in this proceeding.

A. The Universal Service funding burden is, in effect, an assessment, and like all governmental assessments it must be sized and applied in a manner that furthers consumer welfare as a whole, taking into account the social policies furthered by the Universal Service fund

Universal Service is an admirable societal objective that MCI strongly supports, but it is not costless and those costs are not reduced by keeping them hidden. The additional charges or higher prices required to fund Universal Service reduce the purchasing power of consumers and distort their purchasing decisions, as the prices of the assessed services are raised, and the demand reduced, relative to the prices and demand for non-assessed services. Therefore any Universal Service program should be kept as small as possible while still meeting the agreed-upon social objective.

1. The Universal Service subsidy must be defined as the difference between forward-looking economic costs and a nationwide affordability benchmark

The Universal Service subsidy must be explicitly defined and calculated to explicitly identify the size of the social need and to protect against creation of too large of a fund. A fund that is unnecessarily large will artificially raise prices (and harm consumers) in the markets that pay into the fund, without commensurate public benefit.

Universal Service is generally defined in terms of a maximum affordable price that consumers should have to pay for basic local telephone service or a revenue level that a LEC can expect to receive when the rate for basic service is maintained at an affordable level. That price or revenue becomes an affordability benchmark against which the costs of providing service can be compared, to determine the amount of subsidy needed to ensure that consumers in high cost areas do not have to pay more than an affordable rate. MCI will not discuss how to define an affordability benchmark in these comments as the Commission has sought comments, due on May 26, on that specific issue in a separate Public Notice.[3]

For a federal Universal Service fund, it is important that the benchmark be set nationwide, otherwise the residents of a state that chose a low benchmark would be subsidized by the residents of other states not just for costs that exceed the national benchmark but also for the difference between the national benchmark and the low state benchmark.[4]

The cost used in the subsidy calculation should be the forward-looking economic cost of providing service. In order to provide the incentive for efficiency in a market that is not yet competitive, it is appropriate to base the subsidy on the cost that would prevail in a competitive market, where prices and hence costs are driven toward the costs of the most efficient provider using the most efficient technology currently available. The Commission already has a process in place for selecting the cost model and input values needed to estimate these forward-looking economic costs.[5]

In calculating forward-looking costs, it is possible to perform the analysis at varying levels of geographic disaggregation. The smaller the area over which the cost calculations are

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[3]Common Carrier Bureau Further Comment on Selected Issues Regarding the Forward-Looking Economic Cost Mechanism for Universal Service Support, CC Docket Nos. 96-45, 97-160, DA 98-848, May 4, 1998.

[4]This need not be a conscious effort to game the system, but simply the result of a state setting relatively low rates for its residents -- through low basic rates or very broad extended area service (EAS), either of which would result in low revenues as well as low prices. These would represent state-specific decisions that should not impose costs on the residents of other states.

[5]The Commission currently has before it two forward-looking cost models, HAI and BCPM, and is about to address input values for the models. MCI believes that the HAI model estimates costs demonstrably more accurately than BCPM and should be chosen for that reason.

performed, the less the averaging of higher and lower cost customers that would mask high cost customers, and thus the greater the subsidy calculation. But the need for a disaggregated, explicit high cost Universal Service subsidy fund for non-rural LECs should be tied directly to the extent to which the current regime of implicit subsidies are being eroded by competition.

Competitive entry will largely be driven by unbundled network element (UNE) loop rates. Where UNE loop rates are deaveraged to reflect underlying costs, entry can occur in low cost areas and an explicit Universal Service fund will be needed that is based on those deaveraged loop rates. The less deaveraging of UNE loop rates, the less likely local competition will be able to develop. Consequently, the degree of disaggregation used in the Universal Service subsidy calculations need only reflect the level of deaveraging used to set UNE loop rates. At the extreme, if UNE loop rates are not deaveraged at all, then the high averaged loop rate will preclude wide scale competition in low cost areas and the Universal Service subsidy can, and should, be calculated study-area-wide, based on the single, averaged loop rate. In sum, sound public policy principles suggest that the calculations for the explicit Universal Service fund be performed over the same cost zones that each state has used for setting loop rates.

Some parties have suggested that the subsidy calculation should not be based on the difference between forward-looking economic costs and a nationwide affordability benchmark, but rather should be based on a state's ability to provide Universal Service support, with additional interstate support provided based not on affordability but rather on a state's ability to provide Universal Service support from intrastate services while keeping residential rates at current levels. These parties would not base subsidies on a simple comparison of costs and revenues, but rather would provide additional subsidies to states with lower than average proportions of intrastate to interstate revenues. This approach improperly extends the interstate Universal Service assessment beyond the societal goal of assuring all customers affordable rates to a broader objective of redistributing income across states. Another problem is that it only partially addresses the need to move from implicit to explicit subsidies. It improperly assumes that rural states with relatively few low cost residents lack an intrastate source of implicit subsidies and therefore would have to raise rural rates unless they had access to explicit interstate subsidies, but states with large urban populations have sources for Universal Service support from the large implicit subsidies in urban rates and thus do not need explicit interstate subsidies.

Some parties have suggested using embedded costs rather than forward-looking costs for calculating the subsidy — or using the lower of the two. Although it is true that in a competitive market there may be times when rates are driven below forward-looking costs toward the book costs of an established firm with substantial sunk costs, this would not be an equilibrium price; rates would tend toward forward-looking costs as the incumbent firm eventually would have to replace its sunk investments. Thus, even if a subsidy calculation could be smaller using embedded costs in the near term, forward-looking economic cost is the appropriate basis for calculating the subsidy.

In its proposal, GTE proposes an entirely different definition of Universal Service to create an extremely large fund. GTE claims that wherever the rates for interstate or intrastate services exceed the forward looking costs of those services, that gap represents current implicit Universal Service funding and the new explicit Universal Service fund must be equal to that gap.[6] This very clearly is not the proper definition of the Universal Service subsidy, but rather is merely

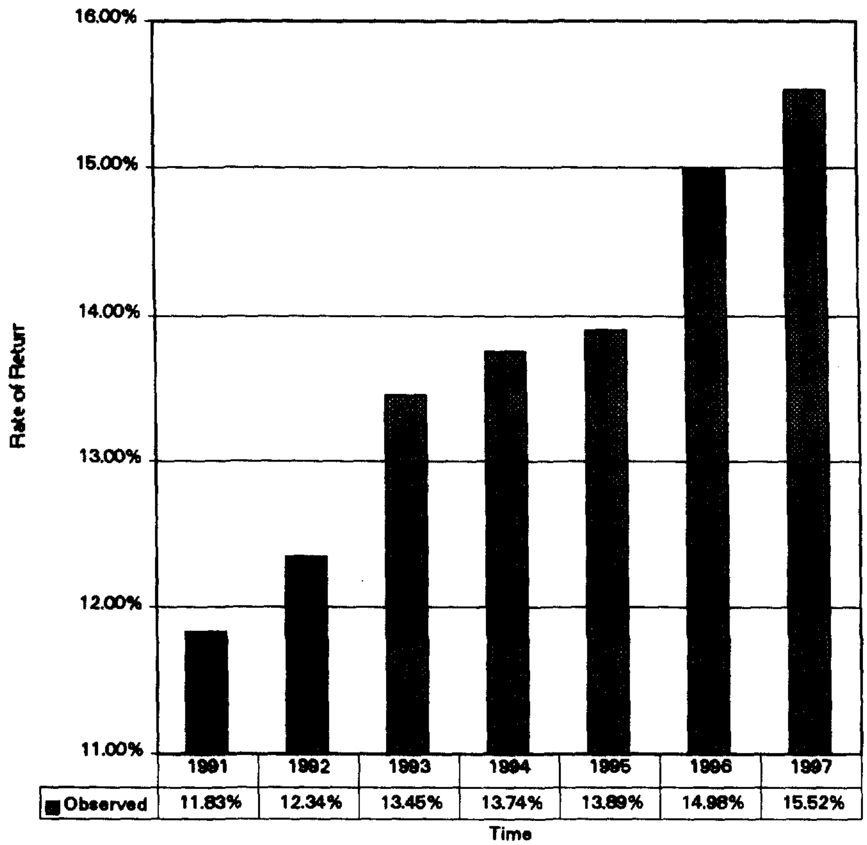
[6]GTE Comments at ii.

an attempt by GTE to perpetuate its current monopoly revenue stream.

This raises a very important issue. So long as the Universal Service support is funded through implicit subsidies, parties are able to claim that any and all rates set above forward-looking economic cost are implicit Universal Service subsidies. The nub of the issue is that prices/revenues for many interstate and intrastate services far exceed costs, but not all of these — indeed only a small share of these — extra revenues are needed to fund the Universal Service subsidy. The gap between rates and per unit costs — or between revenues generated by specific services and the forward-looking economic costs of providing those services — is far greater than the total size of the Universal Service subsidy. Most of these extra revenues simply contribute to the high profits that the non-rural LECS enjoy. Figure 1 shows the continual increase in the interstate earnings of the large LECS. Thus, although both the interstate and the intrastate jurisdictions claim that they have set rates above costs (and have generated revenues that exceed costs) to provide Universal Service funding, it is not correct that all these above cost rates represent implicit Universal Service subsidies. GTE's proposal to inflate the size of the Universal Service fund is particularly harmful to consumers. Once the dollars have been moved from implicit funds to explicit funds, they will be insulated from market forces. While this is beneficial as long as the funds are used to meet real Universal Service needs, it just makes consumers the funders of ILEC excess profits if the fund is too big.[7]

[7]Bell South alleges that the entire gap between interstate revenues and costs represent implicit Universal Service subsidies that must be made explicit. This, too, is an overstatement of the size of the Universal Service subsidy. See, Bell South Proposal at 3.

Figure 1
Interstate Earnings of Tier 1 LECS



2. **For every dollar of explicit subsidy collected, the current implicit subsidies must be decreased a dollar**

Because the Universal Service subsidy currently is collected through hidden assessments in the form of higher prices, charges, or surcharges, every dollar of explicit subsidy collected must be matched by a dollar decrease in the implicit subsidies. Otherwise there will be a doubling of the burden imposed on customers, and the LECs will gain a double recovery. This very important principle has important implications for structuring a Universal Service funding mechanism.

How should one determine which above cost rates do indeed represent implicit Universal Service subsidies that should be reduced one dollar for every dollar collected in the new explicit Universal Service fund? Both fairness and competitive neutrality demand that, to the fullest extent possible, the carriers and customers who bear the burden of the new explicit assessment and are already contributing to existing implicit subsidies actually benefit from the reduction in the implicit burden. If, going forward, the federal jurisdiction were to introduce an explicit Universal Service funding mechanism, collected from users of interstate services, that funded 100% of the Universal Service subsidy, then the above cost rates that are reduced should be interstate access charges. If the explicit funding mechanism is imposed only on interstate services, then the new assessment will be borne by interstate customers. Thus, the reduction in implicit subsidies must be for those implicit subsidies currently borne by interstate customers — otherwise interstate customers will be doubly burdened.

The Universal Service fund cannot be viewed as a means to impose additional costs on interstate customers in order to subsidize states, as several states and state-funded organizations have proposed. Nor is it appropriate to impose an additional burden on interstate services and then decrease rates for intrastate services, claiming that those rates were supporting Universal Service. Indeed, if a decision is made to fund the entire high cost Universal Service fund for non-rural LECs through an explicit charge imposed on interstate services, then all the dollar-for-dollar reductions in implicit subsidies must be in interstate rates. If that were the case, it could not be argued that intrastate rates are providing a Universal Service subsidy except to the extent that a state chooses to keep local rates below the national benchmark level to attain a state-specific affordability benchmark. Thus, there would be no national Universal Service justification for rebalancing intrastate rates. If it were possible to decrease the rates for interstate access charges dollar for dollar and still have access charges that fully recovered their forward-looking economic costs, then any intrastate rates that were above cost (or any remaining interstate rates that exceeded cost) could no longer be justified in terms of providing Universal Service funding. If competition were to drive some of those above-cost intrastate rates toward cost, Universal Service would not be impacted.

B. Universal Service funding mechanisms, like all such programs, must be structured for administrative efficiency and ease

Any funding mechanism must minimize administrative costs. This is especially important when the administrative burden falls on companies rather than government agencies (as in the case of Universal Service support), because it can create an artificial cost disadvantage for some companies.

Efficiency requires that the funds be easily billed and collected. The experience from the PICC demonstrates that the interexchange carriers do not have the kind of billing and collections relationship with customers needed for efficient collection. Only local exchange carriers (whether incumbents or new entrants) have stable, monthly billing arrangements with customers. If the collector has no efficient way to collect the necessary funds, then it bears very high costs over and above the level of the assessment itself. In addition to dollar costs, if a company is forced to be the collector and has no simple way to collect the assessments, it may be forced to use collection methods that annoy customers and therefore could harm its reputation.

A single national Universal Service funding mechanism is much easier to bill and collect — requiring much lower investment in operational support systems — than 50 separate state systems. It also would ensure a single method for calculating the subsidy, thus precluding errant states from gaming the process. While the creation of an interstate funding mechanism to bear 100 percent of the explicit Universal Service fund would not guarantee that some states would not implement their own Universal Service funding mechanism to subsidize rates at levels below the nationwide benchmark, if such a federal program were implemented states would likely see less need for Universal Service funds of their own. However, if the Universal Service burden is fully borne by the interstate jurisdiction and the states are freed of that burden, they will not have an incentive to control the size of the fund and certainly will be importuned by the LECs in their states to push for a large federal fund. This must be resisted.

C. The Universal Service funding mechanism must be imposed in a competitively-neutral fashion

The Universal Service funding mechanism must be imposed in a competitively-neutral fashion. It is not sufficient to claim that making the Universal Service funds portable and available to all local exchange providers makes the mechanism competitively neutral. The assessment and collection burden also must be imposed in a competitively neutral fashion.

With the convergence of previously separate telecommunications markets, Universal Service funding imposed primarily on one segment of the industry — or funding, that one segment of the industry can pass on to another segment, as the Commission has allowed the

ILECs to flow-through their universal service obligations to IXCs — will distort competition by raising the costs of some competitors but not others. The more heavily burdened competitors can be harmed in one of two ways. If the Universal Service charge is not made explicit, it will appear to customers to be a price increase only some competitors, thus hurting those companys' images, as well as placing them it at a price disadvantage in relation to other competitors. Alternatively, if some competitors cannot recover the Universal Service assessment through a separate charge, or for market reasons cannot pass the assessment through to its customers, and thus must "swallow" it, then it will have its cash flow artificially decreased and will be placed in a competitively weaker position. Given the very high investment costs associated with entry into the local exchange market, imposing such costs on new entrants, or a subset of entrants (such as the IXCs), undermines their ability to provide an alternative to the ILECs.

Because all segments of the telecommunications industry ultimately will be competing with one another (at least if the RBOCs choose to comply with the legal requirements of the Telecommunications Act), this might suggest that the Universal Service burden should be imposed on both interstate and intrastate services. This is not necessarily the right approach. If the assessment on intrastate services ends up being passed along to interstate services — and in a hidden fashion — IXCs will be burdened with the risks associated with collecting the ILEC share. This creates the worst of all worlds, as access charge increases simply increase the IXCs' costs, but these additional costs are not separately identified and recovered as Universal Service charges.

D. The Universal Service fund must be implemented in a fashion that is consistent with implementation of other key elements of the Telecommunications Act

The Universal Service fund should be implemented in a fashion and on a schedule that is consistent with, and provides incentives for, implementation of the other key elements of the Telecommunications Act — in particular, interconnection through access to unbundled elements at rates that reflect forward-looking economic cost and access charge reform. As explained earlier, if a state has not deaveraged the rates for unbundled loops, at levels based on forward-looking economic cost, then new entrants would not be able to compete with ILECs in low cost areas. Efficient competitive entry that could erode the above cost rates in urban areas would not be possible, so the non-rural ILECs would have no need for disaggregated, explicit, high cost funding to replace the current system of implicit subsidies. One way to provide states with the incentive to deaverage rates for unbundled loops, so that efficient competition could develop, is for the FCC to calculate the interstate Universal Service subsidy for each state based on the same level of disaggregation/deavearaging as the state employs in setting its loop rates. In states that fail to deaverage loop rates, the forward-looking economic cost used to calculate the interstate subsidy would be the average cost over the entire study area. Such a broad cost average probably would yield little, if any, high cost Universal Service subsidy for most non-rural LECs in the state since low urban costs would mask high rural costs, but this would be consistent with the way UNE loop rates were set in the state and with the way the current USF is set.[8]

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[8]This approach would have two additional benefits. First, it is administratively simple because the FCC doesn't have to revisit the issue of what the relevant level of disaggregation is; the individual states would decide that. Second, by adopting this approach, the Commission would be displaying a spirit of comity with the states, building on the states' determination of what is best for their own local conditions, while providing an incentive for the states to put in

III. All high cost non-rural Universal Service fund proposals submitted to date have serious flaws that render them inconsistent with sound public policy principles

A. The State Proposals would harm consumers and competition in order to solve a problem that does not exist

1. The State Proposals would impose a double burden on interstate customers and would give non-rural LECs double recovery

The State Proposals[9] submitted to date appear to be motivated by two Commission actions that the states fear would threaten the affordability of local rates in high-cost areas of states with a relatively low ratio of intrastate to interstate revenues. These two actions are: (1) the proposal to fund only 25 percent of the Universal Service subsidy from the interstate jurisdiction, and (2) the decision requiring non-rural carriers that draw upon high cost support to satisfy interstate revenue requirements that would otherwise be collected through interstate access charges,[10] thereby shifting revenue requirements to the states. Their argument is that if most of the Universal Service funding burden had to come from intrastate services, states with a relatively low ratio of intrastate revenues to interstate revenues in conjunction with future competitive pressure on above cost intrastate rates, could be required to raise rural rates beyond the range of affordability.

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place UNE loop rate deaveraging that would foster competition.

[9]State Proposals include Ad Hoc's Proposal, Options 2-6 in the TIAP Paper, US West's IHCAP Proposal, and the Variable Benchmark Options Proposed by Colorado and South Dakota. Hereinafter, these proposals will be referred to as "State Proposals."

[10]Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing and End User Common Line Charges, CC Docket Nos. 96-262, 94-1, 91-213, and 95-72, (1977) *Access Charge Reform Order*, 12 FCC Rcd at 16148, para. 381.

Thus, the State Proposals call for the interstate jurisdiction to fund more than 25 percent of the Universal Service subsidy. That, in itself, might be a reasonable proposal, but in each case the proposals incorporate other provisions that would both harm consumers and undermine competition. Most blatantly, rather than proposing that the new explicit interstate funding mechanism be matched with commensurate decreases in existing implicit subsidies in interstate rates, these proposals either would not require any decrease in implicit funding (thus giving the non-rural LECs double recovery and imposing a double burden on consumers) or they would decrease existing implicit subsidies in intrastate rather than in interstate rates (thus forcing interstate customers to bear both implicit and explicit funding burdens).[11] The proposals are inconsistent with sound public policy principles.

2. The State Proposals respond to a non-existent problem

Moreover, the alleged problem that the State Proposals are intended to correct does not exist. It was created out of a combination of Ad Hoc overstating the potential funding problem and not accepting that the FCC revenue requirement decision could readily be reversed or re-interpreted to eliminate the problem.

Ad Hoc was an early critic of the Commission's proposal to fund 25 percent of the forward looking subsidy of non-rural carriers. Subsequent critics have relied on Ad Hoc's contention that requiring states to fund the 75 percent of the forward looking subsidy estimate would force significant percentage increases in intrastate rates, especially states lacking a large urban core. However, Ad Hoc grossly misrepresents the potential impact on states from having

[11] See, for example, the comments of Ad Hoc at 28; Colorado at 3; John Staurulakis, Inc. at 9; U S West at 2.

25 percent of the forward looking subsidy estimate of non-rural carriers funded at the federal jurisdiction. Ad Hoc contends that some states such as Montana and South Dakota would need to raise rates by as much as 30 percent of state revenues.[12] However, using the HAI model, 75 percent of the forward looking subsidy estimate is $1.7 billion, amounting to 1½ percent of state revenues.[13] Under the FCC Plan, 75 percent of the forward looking subsidy estimate for non-rural carriers amounts to no more than 4 percent of revenues in South Dakota and Montana.[14] In short, Ad Hoc and other State Proposals fail to show that states have any need for additional federal subsidy revenues.

State Proposals also are premised on the belief that the Commission's decision requiring non-rural carriers that draw upon high cost support to satisfy interstate revenue requirements that would otherwise be collected through interstate access charges shifts revenue requirements to the states, and once again threatens local affordability. According to USAC, non-rural carriers will transfer $217 million in additional expense adjustments to the interstate jurisdiction in 1998.[15] States overstate the difficulty of solving this problem. Using the HAI model, non-rural carriers would stand to receive $570 million in forward-looking subsidies in 1999 under the FCC Plan.

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[12]Ad Hoc achieves this sleight of hand by including the forward looking subsidy requirement for rural carriers. See, Ad Hoc at 6. All parties agree that issues in this proceeding should be limited to non-rural carriers.

[13]Ad Hoc uses the HAI model in its calculations that document the states' need for additional federal revenues.

[14]Payers and Receivers: Various Proposals for the High Cost Fund, Ex Parte Submission, March 11, 1998, *TIAP Proposals* at 27, and Appendix D at 59.

[15]Federal Universal Service Programs, Fund Size Projections and Contribution Base for First Quarter, 1998, USAC, October 31, 1997.

The Commission may simply clarify its rules to allow non-rural carriers to continue to book costs pursuant to 47 U.S.C. § 36.361 and apply the funds they withdraw for high cost purposes to this specific interstate revenue requirement before reducing interstate access charges. Non-rural carriers that would receive forward-looking subsidies greater than their additional expense adjustment should be required to reduce interstate access charges for every subsidy dollar in excess of the additional expense adjustment in order to prevent double recovery of subsidies.[16]

B. State Proposals would harm the welfare of rural customers

All the State Proposals fail to meet the principle that implicit subsidies must be reduced dollar for dollar concurrent with the introduction of a new explicit Universal Service fund. State proposals would simply increase subsidy payments to the largest ILECs without reducing either interstate or intrastate rates. The States apparently, feel justified in this unilateral transfer of revenues from the interstate jurisdiction because they believe that the Commission's Access Charge Reform Order unilaterally transfers costs from the interstate jurisdiction to the states. Once the Commission adopts the clarification recommended above however, there will no longer remain a rational basis not to reduce implicit subsidies upon establishing the new explicit fund.

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[16]There is no reason to believe that the amount by which 1999 forward looking subsidies are less than the 1998 additional expense adjustment represents anything other than the normal variation in annual loop costs that occurs under the existing Part 36 cost and subsidy determination. Years in which loop investments and expenses are high will be years in which eligible companies will receive higher subsidies, and years in which investments and expenses are low will be years in which eligible companies will receive fewer subsidies. Over time these variations cancel each other out. The companies that would receive smaller forward looking subsidies in 1999 than they received in 1998 would be just as likely to receive smaller subsidies in 1999 had embedded subsidy calculations continued. Consequently, there is no need to hold companies harmless for the changeover to forward looking subsidy calculations, since they would not have been held harmless for the same changes that would have occurred under embedded subsidy calculations.

Ironically, once this clarification is adopted, the State Proposals to increase federal subsidy responsibility for non-rural carriers actually would serve to reduce the welfare of customers served by the smallest, rural carriers. All the State Proposals hold rural company subsidy receipts constant, and increase funding to non-rural carriers above existing levels without requiring commensurate reductions in interstate access rates. Since interexchange carriers would be required under §254(g) of the 1996 Act to collect these additional Universal Service funds from all of their customers, including rural customers, the welfare of rural consumers will be reduced. Thus, the State Proposals would benefit the large non-rural ILECs at the expense of customers served by smaller, rural carriers. For this reason alone, the Commission should reject the State Proposals.

C. GTE and Bell South violate sound policy principles by proposing universal service funds that are too large

The Commission recognized that if interstate access charges were not reduced for every dollar of implicit subsidy made explicit, ILECs would recover subsidies twice — once through remaining implicit subsidies, and once through the new explicit subsidy. Section 254 requires the Commission to establish an explicit and *sufficient* universal service fund, not an *excessively-sized* universal service fund. Since the Commission would not be able to identify the full extent of subsidies contained in interstate access charges until after it adopted its forward looking cost model, it rightly abstained from folding ALL the above-cost revenues currently recovered in interstate access charges into an explicit universal service fund.[17] Bell South and GTE reiterate ILEC proposals to recover all the "contribution" from interstate rates that exceed cost through a

[17]Universal Service Order at ¶13.

new explicit Universal Service fund, even before the Commission has adopted a cost model that would identify the size and location of the Universal Service subsidies.[18] Once again, the Commission must reject these attempts to recover fat and excess profits under the guise of Universal Service.

D. A variable benchmark violates sound public policy principles

South Dakota and Colorado propose varying the benchmark across states according to some measure of a state's ability to "internally support and fund universal service requirements. States that have a relatively low ability to internally support universal service would have a relatively low benchmark, while states that have a relatively high ability to internally support universal service would have a relatively high benchmark."[19]

One rationale for a variable benchmark is the belief that rural states do not have implicit subsidies to draw on to internally support universal service. The revenue base argument has been refuted earlier in these comments.[20] Under the FCC Plan no state would have a forward looking subsidy requirement estimate for non-rural carriers greater than 6 percent of its revenues. On average this requirement amounts to only 1½ percent of state revenues.

A fall back position supporting South Dakota and Colorado might be that even if the subsidy requirement is not a large percentage of state revenues, states have unique cost characteristics that are not captured by a single national benchmark. That is, states characterized by many high cost customers, with few low cost areas of implicit support to draw on, have higher

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[18]Bell South at 3; GTE at 11.

[19]South Dakota Proposal at 3.

[20]See, Section III.A.2, above.